Changes in Combined Federal/State Marginal Individual Income Tax Rates for High Income Filers Under SB407, 2003 Legislature

Economic development may be hampered when a state's tax rates are significantly out of line with those in competing and neighboring states. A comparative analysis of marginal individual income tax rates among nine neighboring and Rocky Mountain states prior to the 2003 Legislative Session indicated that Montana's tax rates on ordinary income were among the highest in the region, and that the state's tax rate on capital gains income was the highest.

Governor Martz's Individual Income Tax Advisory Council recommended reducing the top marginal tax rate from 11% to 6.9%, capping the state's deduction for federal income taxes paid during the year at $5,000 ($10,000 if filing jointly), and providing for a capital gains tax credit to provide further relief on a source of income deemed especially important to capital and economic development. These goals were achieved in Senate Bill 407.

The following tables provide a comparison of Montana's relative marginal tax rate ranking among the nine states in the study before and after SB407, for high income individuals (taxpayers facing the state's 11% top marginal tax rate). The rates in the following table represent the difference between the combined federal/state marginal tax rate for each state relative to a state like Wyoming, which has no individual income tax.

When entrepreneurs contemplate location decisions they are influenced by the total amount of individual income taxes they will pay. This includes both federal and state income taxes. For high income individuals, locations decisions are influenced by the combined federal/state marginal tax rate, which is determined by federal tax policy and the tax policy of each individual state. These marginal rates are further determined by the ability to deduct state income taxes for federal income tax purposes, and whether or not the taxpayer is able to deduct federal income taxes for state tax purposes. Mutual deductibility, such as we have currently in Montana, results in a lower marginal tax rate than in states that do not allow a deduction for federal taxes.

These relationships are captured in marginal tax rate formulas that take each state's tax policy into account in the following tables. The following page provides examples of the formulas used to calculate the combined federal/state marginal tax rate, and shows how the differential, relative to a state like Wyoming, is calculated.

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